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SUBJECT: THE 2006 IRAQI BUDGET

Classified By: Acting Deputy Chief of Mission David Litt for reasons 1.
4 (B) and (D)

¶11. (SBU) Summary: Iraq's 2006 budget is a bold document that tackles subsidy reform, greater Iraqi burden-sharing in the security ministries, and sustainment. Unlike 2005, when Iraq had a budget surplus (largely through higher than anticipated oil revenues), so far this year Iraq is getting less oil revenue than anticipated. Under its IMF Standby Arrangement, Iraq is constrained from obtaining external financing for a budget deficit, so the incoming government might face the painful prospect of budget cuts later this year. While the Ministry of Finance (MoF) drives much of the budget process, the budget remains part of a political process in which legislators are particularly interested in increases in spending for the provinces and pensions. End Summary.

A Bold, Forward-Looking Document

¶12. (SBU) The 2006 Iraqi budget is the first Iraqi national budget to use fiscal processes as tools for macro-economic restructuring and reform. The 2006 budget is an ambitious balancing act that phases out subsidies (universal entitlements) and lays the groundwork for a social safety net (means-tested welfare). It accents greater investment in the oil sector to increase revenues to levels sufficient to meet long-term challenges. This budget also allocates funds for some decentralization of government spending from the national to the provincial levels, and it plans for an eventual takeover by Iraqi forces of national security responsibilities from the Coalition.

Hard Beginnings: Austerity Measures Underway

¶13. (SBU) Iraq's 2006 budget is already stressed. First quarter oil revenues will be lower than anticipated, and outlays for fuel imports and payrolls (particularly for increased security forces) will be higher. Until oil export revenues recover, the Ministry of Finance (MoF) is carefully husbanding the declining cash balance in its petroleum revenue account (aka the DFI), which must also be drawn upon to pay for fuel import payments arrears accumulated during ¶2005. The MoF is already limiting its releases of funds to the most essential items -- salaries, food and (in a measured way) the provincial accounts. If oil revenues do not improve substantially, Iraq's mid-year budget supplemental could call for budget cuts -- not the increases that many are hoping for.

Planned 2006 Spending

¶14. (SBU) Planned expenditures for 2006 increased by a total of \$10.5 billion to \$34.0 billion, up by 45 percent from

\$23.5 billion in 2005:

-- One-third of the increase (\$3.2 billion) went to the security ministries (Interior and Defense), whose budgets together increased by about 150 percent from \$2.1 billion to \$5.3 billion.

-- The budget for the provinces increased by \$2.4 billion, including first-time allocations totaling \$2.0 billion for the non-Kurdish provinces to spend for development projects, and a \$0.4 billion increase for Kurdistan (upping its direct allocation to \$2.9 billion).

-- The budgets for the essential services ministries increased by \$1.2 billion, almost all for capital spending to boost oil revenues and electricity supplies.

-- The MoF's own budget increased by \$3.1 billion, of which \$1.3 billion is allocated for an estimated doubling in funding for government pensions. In its last days the outgoing Transitional National Assembly passed a new Pension Law that many feared would be overly generous, creating new liabilities even greater than the expected increase. However, subsequent work on implementing rules reportedly has dampened the effect of the law such that pension liabilities now appear to be within budget (septel).

-- The rest of the MoF budget increase is to help pay down some of Iraq's foreign commercial debts, initiate the restructuring of state-owned banks, fund the beginnings of a new social safety net program (for means-tested welfare system), and establish a development bank to meet provincial needs and augment the contingency reserve.

BAGHDAD 00000955 002 OF 005

-- The MoF's budget for food subsidies (the Public Distribution System) was cut by \$1 billion or 25 percent to \$3 billion, while the budget for fuel imports was unchanged at about \$2.7 billion.

Hiring Boom for Security Forces and Sustainment

15. (SBU) The budget for government salaries in all ministries and regions increased by \$2.4 billion or 80 percent to \$5.4 billion. There are already indications that actual needs may be even greater. Government hiring is increasing rapidly -- particularly in the security ministries. The security ministry staffs (civilian and uniformed) now receive generous hazardous duty allowances that at lower grade levels more than double take home pay. The security ministries account for 2/3 of all government salary increases. The next largest increase went to the education ministries (up \$0.3 billion by about 25 percent). The portions of the budget devoted to sustainment (services, maintenance, and supplies) increased by \$1.9 billion to \$3.7 billion, up 110 percent. Almost all of the increase in sustainment (\$1.7 billion) went to the security ministries.

The Rise of the 2005 Budget Surplus

16. (SBU) As previously noted, there are substantial additional expenses still to be booked against the year-end 2005 budget surplus. Budget revenues for 2005 came in at an estimated \$25.0 billion, or nearly \$6 billion above planned revenues of \$19.3 billion. Actual 2005 oil revenues as reported to the Central Bank were \$23.0 billion versus planned revenues of \$17.1 billion. 2005 crude oil exports averaged 1.42 million barrels per day (mmbd) at an average export price of \$44.46 per barrel. Non-oil revenue receipts were an estimated \$2.0 billion (about 10 percent below plan, reflecting difficulties in customs collections). Information

on budget releases through October suggests that the 2005 budget was under-spent by about \$1.5 billion, with outlays totaling \$22.0 billion rather than the planned \$23.5 billion.

Thus, at year-end the 2005 budget showed a roughly \$3.0 billion surplus rather than a planned deficit of about \$4.2 billion.

And Its Fall

¶ 7. (SBU) Since year-end, however, charges against the 2005 budget surplus have continued to accumulate. The recent settlement with Turkey to pay arrears for fuel imports ordered and received in 2005 will be charged against the 2005 budget. There are also yet-to-be-settled arrears owed to Kuwait. Together the arrears could total \$1.3-1.4 billion.

Dollar and Dinar Balances

¶ 8. (C) At the ends of 2004 and 2005, and on March 1, 2006, the MoF's account balances (in billions of dollars equivalent converted at USD 1 = ID 1,500; excluding the DFI transition account) were as follows:

	FRB-NY	CBI-ID	CBI-USD	Total
	-----	-----	-----	-----
31 Dec 04	3.5	0.4	0.1	4.0
31 Dec 05	4.6	1.9	1.0	7.5
01 Mar 06	4.6	1.6	0.5	6.7
12 Mar 06	n/a	1.9	0.0	n/a

On March 12, 2006 the MoF's dollar balance with the Central Bank of Iraq (CBI) in Baghdad was zero, while its dinar balance rose to about \$1.9 billion. (MoF's FRB-NY balance is not yet known.) While some of the dollar cash may have gone toward making dollar payments (e.g., for PDS system food import letters of credit), most was probably sold to the CBI to supply its daily foreign exchange auction.

Minimum and Available Balances

¶ 9. (C) Prudent budgetary principles suggest that the MoF maintain (not go below) minimum balances of about \$2.8 billion and \$1.0 billion (\$3.8 billion total) respectively between its accounts in New York and Baghdad. The former figure represents one month's forward cover of the MoF's

BAGHDAD 00000955 003 OF 005

average monthly outlays under the 2006 budget (\$34 billion divided by 12). The latter represents an emergency reserve to meet sudden unexpected demands: e.g., to mobilize cash to address a post-conflict situation (as was needed immediately following the conflicts in Najaf and Fallujah) or to pay for oil infrastructure repairs following insurgent attacks (e.g., in Kirkuk). And a further \$1.0 billion or so needs to be set aside to pay for expenses incurred under the 2005 budget that are yet to be settled in 2006 (e.g., for the fuel import arrears). Thus, at the beginning of March 2006, the MoF's prudently available balance was only about \$1.9 billion (\$6.7 billion minus its minimum balances and the amounts owed against 2005 liabilities) -- giving the MoF a small cushion.

Limited Deficit Funding Options

¶ 10. (C) The roughly \$1.9 billion is what is available to finance GoI budget deficits that might arise during the remainder of 2006 but is only about half of what is needed to cover the planned 2006 budget deficit of \$3.7 billion. (The

planned deficit number, which was decided before the extent of fuel imports payments arrears and other end-2005 emergency expenditures were known, could be too low.) Under its Paris Club and IMF agreements the MoF has little latitude to borrow in order to cover budget deficits, nor is it allowed to seek direct budget support from donors in this area. Aside from running down its balances, the MoF's other deficit financing options are asset sales (none of any size are presently planned) or Saddam-era assets recoveries (e.g., the diminishing amounts still held by some offshore banks).

2006 Budget Outlook

¶11. (C) Q1-2006 Revenue Shortfall: To meet its 2006 oil revenue objective of \$28 billion, Iraq needs to earn on average about \$2.3 billion per month or slightly under \$7.0 billion per quarter. The 2006 budget plan calls for export volumes and prices averaging 1.65 mmb/d at \$46.60 per barrel.

First quarter 2006 revenues are unlikely to exceed \$4.6 billion, about \$2.4 billion below the quarterly target. Based on previous experience, we estimate a 45-60 day lag between when Iraqi oil is loaded and the revenues are received. Thus, the very low export volumes seen at the end of 2005 and beginning of 2006 affected January and February revenues (\$1.5 billion and \$1.6 billion, respectively) and March revenues are unlikely to exceed \$1.4 billion despite presently high global oil prices. (These data are based on actual daily LC payment reports as received by the Central Bank of Iraq.)

¶12. (SBU) Rest of Year Oil Revenues: To achieve its \$28 billion annual oil revenue goal, Iraq will need to earn \$23.5 billion during the remaining three quarters of 2006. If oil export volumes can be increased enough to average the targeted 1.65 mmb/d, Iraqi oil export prices will need to average about \$52 per barrel, equivalent to \$60-65 per barrel for benchmark crudes like West Texas Intermediate (WTI) or Brent. Since January 2005, Iraq's average monthly export volumes have never reached as high as 1.65 mmb/d, exceeding 1.6 mmb/d only twice (January 05 and August 05). The highest export price seen so far was about \$58 per barrel in October 2005; more recently prices have ranged from \$49 to 52 per barrel.

Reality Check

¶13. (C) Our above analysis is based on many conversations and meetings with working-level MoF officials. We asked the MoF Director General for Accounts for his plan to cope with a revenue shortfall. He told us that the MoF is limiting outlays to the most essential items -- salaries, certain supplies, food, and the minimum amount needed to restart fuel imports under fully funded letters of credit. We have heard reports by other ministries complaining of shortfalls and delays. For example, Ministry of Health officials complain that funds are not being released for purchases of necessary supplies. We have also heard that the housing compensation program for families affected by conflict in Fallujah has slowed.

More to Come

¶14. (SBU) Several areas will continue to put pressure on the Ministry of Finance's coping skills during the remainder of

BAGHDAD 00000955 004 OF 005

2006 -- government salaries and headcount, provincial finances, subsidies and pensions.

-- From 2005 to 2006, the total amount budgeted for

government salaries increased by 80 percent from \$3.0 billion to \$5.4 billion, respectively. Two-thirds of the increase went to the security ministries whose respective salary budgets (including for hazardous duty pay) rose from \$0.8 billion to \$1.6 billion.

-- Total government headcount (excluding the employees of most state-owned companies) rose by 67 percent from 1.1 million in 2005 to 1.9 million in 2006. Again, the biggest increase was with the security ministries, which together added about 380,000 slots, bringing their total headcount (i.e., a ceiling or an upper limit) to about 540,000 (160,000 and 378,000 for Defense and Interior, respectively). Please note that neither Ministry has reached these ceilings. From a budget perspective, security ministry employees are especially expensive because they also receive hazardous duty allowances (civilian and uniformed). The Kurdish provinces of Sulaimaniyah and Erbil added almost 200,000 to bring their headcount to about 560,000 -- or 30 percent of the nation's total government headcount. For comparison purposes, the population of Kurdistan is estimated at 17 percent of the total population of Iraq. The Ministry of Education also made a large gain in headcount, rising 47 percent to almost 495,000.

New Provincial Funds

¶15. (SBU) Two one-billion dollar funds were set aside in the budget to be spent by the provinces (excluding Kurdistan, which receives its own lump sum share of the budget). One fund is for immediate reconstruction needs, and the other is for longer-term development projects where 10 percent of the fund was held back to cover contingencies. Both funds were allocated according to provincial population such that Baghdad and environs received 27 percent, followed by Ninawa and Basrah at 9-11 percent, Diyala, Anbar, Babil and Dhi Qar at 5-6 percent each, and the rest at 4 percent or less. The MoF has taken several steps aimed at enabling the provinces to access and spend these amounts, including putting MoF staff in the provinces and bringing the provinces' chief financial officers (their "Treasurers") to Baghdad for briefings on how the funds can be used. While the new constitution devolves to the provinces considerable authority over spending, most provincial governments lack the trained finance and contracting staffs needed to spend the money responsibly. Capacity building, particularly for finance, will be a major challenge for 2006 and 2007.

Subsidies

¶16. (SBU) The budget for subsidies of all kinds (fuel, food, medicine, state-owned enterprises, etc.) was cut from \$8.3 billion to \$7.5 billion, reflecting a \$1 billion cut in the allocation for food purchases from \$4 billion to \$3 billion against a small increase in the allocation that supports the state-owned enterprises. The fuel subsidy was held approximately unchanged at about \$2.7 billion.

Pensions

¶17. (SBU) The 2006 allocation for government pensions is \$3.0 billion, up 80% from \$1.7 billion in 2005. The big increase was to anticipate pension reforms providing for graduated retirement benefits set according to age, time in service, and rank. A major factor bloating ministry headcounts has been the reluctance of employees to retire because the pension benefits on offer are too small and not graduated. During its last days the Iraqi Transitional National Assembly passed a new "Unified Pension Law," but without the benefit of pension experts the result was internally contradictory. If wrongly applied, the new law could have been grossly over-generous and unaffordable. Subsequent rule-making

appears to have addressed these concerns and brought the new pension scheme in line with the 2006 budget.

Comment

¶18. (SBU) The 2006 budget ambitiously plans increased spending for security, capital investment, payrolls and the provinces over previous budgets. If oil revenues grow and

BAGHDAD 00000955 005 OF 005

subsidies continue to be trimmed as planned, Iraq will be able to carry an even greater share of the burden for its own security in 2007, and provincial spending will have even more room to grow. However, developing the capacity of the financial staffs of the security ministries and provinces to formulate and execute their budgets responsibly is a challenge that circumscribes prospects for fiscal and financial success for Iraq and its donors.

KHALILZAD